ABI response to 'The future of retirement: A consultation on investing for NEST's members in a new regulatory landscape'
March 2015

About the ABI
The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 250 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:
- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

We welcome the opportunity to respond to the consultation on NEST's call for evidence on how to make Defined Contribution pensions secure good retirement outcomes for automatically enrolled savers in the context of both the pension freedoms and changing retirement patterns.

Consultation questions

1. How will the trend for changing retirement patterns and provision affect what:

a. members need, and

b. employers want, from DC schemes in the future?

As more people retire with DC pension pots, and these pots become more likely to be someone's main source of income, they will require a wider range of products to suit a more diverse range of needs. This must go hand in hand with effective guidance to allow people to make the most of the expanded choice available.

The ABI feels that providers should begin a discussion with members about their retirement options at an early stage, at least 10-15 years before their retirement date. This will give members the time and perspective to view their choice of retirement product within the context of a whole host of other factors such as personal levels of debt, assets and sources of income they have besides a pension, and the potential social care needs of either them or their partner. On the back of this conversation, individuals can start to think of a target retirement income, and take an informed view of when they should finish work.

Better communication between providers and members during the accumulation phase is also valuable to ensure that members are aware that they are getting value for money. This also helps to keep members engaged with their pensions throughout their life.

Changing retirement (and socio-demographic) patterns will affect what savers need: longer lives and working lives, combined with increasing health inequalities and changing family structures are likely to mean that flexibility is required to meet the range of needs that savers have. The inevitability that some customers will not engage reinforces that this is a challenge.

2. How will the trends identified in this chapter evolve and what does this mean for DC design?

Retirement scenarios are likely to get even more complex in the future, with DC pension pots being expected to deliver more income to people due to longer life expectancy and higher personal debt levels.

Good communication between members and providers will therefore be even more key. Communication is likely to take more digital forms in future as the retiring population becomes more literate in these types of technologies. These will improve disclosure of the costs and performance of DC schemes.

4. Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?

People are likely to have different spending patterns and different needs, but broadly the majority will want to balance having some form of consistent income throughout their life with the liquidity necessary to withstand any financial shocks.

The range of retirement products on offer is already very broad, and is likely to expand even further after the reforms come into force. Increasingly, people are more likely to combine different retirement solutions in order to be able to access different amounts of money throughout their retirement.

In order for more products to be developed, it is important that prescriptive solutions are avoided in order to give providers the space to innovate.

5. Taking into account current retirement decisions, what people say they want and what the evidence says about behavioural biases, how are savers likely to act under the new freedoms?

Customer behaviour in the new environment is difficult to predict. It will be heavily influenced by how the reforms are implemented, such as how guidance is provided and changes to the tax framework. In addition, customers possess diverse preferences and biases that will lead them to make different decisions.

A simplistic explanation would say that widespread present bias, a desire to have money sooner, combined with the freedoms provided by the reforms will mean that more savers will withdraw their money early rather than leaving it invested or purchasing a retirement product. However, other preferences such as risk aversion will encourage others to finance their retirement in a more traditional way.

The ABI has always supported the provision of a strong system of guidance that covers a broad range of areas. If customers are provided with guidance that allows them to accurately look at the costs and benefits of a variety of retirement options, then the new freedoms should allow savers to select an option more appropriate to their needs.

One of the main issues in the current market is widespread inertia – which manifests itself in a number of ways. Members are often not engaged in what fund their pension is invested in, which may be poor performing or have high fees. Many customers simply purchase an annuity with their current provider as their retirement approaches, with the decision often driven by access to the tax-free lump sum. This inertia will likely persist after the reforms, but with different behaviours, for example simply withdrawing cash in small amounts without really planning how to make it last. This could mean that new choice architecture should be created to protect those who do not shop around.

6. What member behavioural risks do providers need to manage?
And
7. Are there other risks and objectives to be taken into account for DC savers approaching and in retirement?

One main risk has already been referred to – present bias. This currently leads to many people purchasing a single life level annuity, the real value of which will fall over time. In the future, this could manifest itself in people withdrawing all or most of their savings in cash early in their retirement.

This exposes members to the risk that they will either run out of funds before they die or be unable to leave an adequate sum or income for any dependents, as well as the risk that their income will not keep up with inflation. These are known as longevity risk and inflation risk respectively. The risk of the former is exacerbated by the fact that people tend to underestimate their life expectancy.

There are also risks attached to the reverse kind of behaviour. If an individual's income is spread too thinly across their lifetime they may be poorly prepared for financial shocks. They also expose themselves to a risk that they will die without having made full use of their savings.

Seeing a financial adviser can mitigate much of this risk. However, some customers feel that using a financial adviser or other intermediary is prohibitively expensive, particularly if they have a small pot. However, often customers are not aware of how much financial advice can improve the value and security of their retirement income.

In addition, investment risk will be more prominent for a greater number of savers and retirees. Aligned to this, it will be more difficult to recover from early losses if withdrawing funds; and savers may not know their own attitude to risk until faced with losses.

8. What works in terms of communicating and getting DC savers to engage with decision making in the approach to retirement? How can we help members make good choices before and during retirement?

We believe that a broad and ongoing conversation between provider and member is an effective way of ensuring that savers are aware of the financial risks they face in retirement, and take steps to mitigate them by purchasing an appropriate retirement product. Our Code of Conduct on Retirement Choices requires our members to get in touch with their customers two to five years ahead of their retirement date to explain choices they need to make.

It is particularly difficult to engage those with smaller pension pots. As pot sizes increase, we will see more people take an active role in shopping around. However, awareness is increasing as more people retire with DC pension pots, and people are more likely to have friends and family who have already been through the retirement process.

Evidence from other markets suggests that increased internet access causes people to shop around more. Retirees are now increasingly likely to be internet users.

9. How can we help mitigate the risks associated with cognitive decline as people get older?

Our members are committed to engaging customers about retirement decisions at an early stage.

A guaranteed income throughout life is an effective way of protecting against the risk of cognitive decline, as it reduces the need to be constantly making financial decisions. For those who choose an option besides an annuity, products that convert to an annuity or a higher-paying income triggered by a care need would help mitigate this risk.

10. What is the role of default strategies in the new regime and the run up to and throughout retirement?

The priority should be to engage customers to select their own retirement product, as people will have different preferences based on their individual circumstances and should as far as possible be encouraged to express these.

However, where this is not possible some form of default or choice architecture will be necessary. The ABI feels that the nature of the ‘default’ option should be up to the individual company, rather than be prescribed by government. This would reflect the fact that there is no one size fits all solution, and give providers the space to innovate.

11. Should we consider having more than one default strategy for different types of member, and which variables can be reasonably used to differentiate member needs in the event of no member engagement?

This is a matter for NEST and not appropriate for us to comment on strategy, although we agree it is a challenge that needs to be addressed by providers of long-term products.

12. Based on the member evidence presented should the default target retirement age remain the same as state pension age? If not what are the alternatives?

In contract-based schemes, defaults are typically geared to the customer's selected retirement date (which is often State Pension Age). It is sometimes argued that this is arbitrary and irrelevant to customers' circumstances, and this is likely to be reviewed as part of the FCA's review of retirement rules this year.

13. Based on the evidence presented, should purchasing annuity income be part of retirement planning for DC savers? If so - on average - what age should this purchase happen?

Yes. Research consistently shows that annuities can offer good value for money, and for most people will be the only way of guaranteeing income for life.

ABI sales statistics show that the average age for annuity purchase has been consistently around 62. There is a general view that this is too young; remaining in work and contributing to a pension will lead to higher retirement incomes at an age when a secure non-work income is required, especially given increased longevity and potential care needs. However, the money's worth and the total lifetime income of an annuity are higher if bought younger, for a person who is no longer contributing to the pension. This reinforces the notion that individual circumstances and overall lifetime income needs matter.

14. Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?

It is difficult to judge whether alternative solutions would be "better". These have one advantage over lifetime annuities, which is a reduced timing risk in relation to annuity rates. However, this is easily over-emphasised – although it is accepted that annuity rates have fallen, a single level annuity has provided between 5% and 7% per year for the last 10 years. Phased annuitisation and fixed-term annuities already exist, but are not taken up in great number.

15. Should deferred annuities be included in the toolkit for DC retirement solutions?

Deferred annuities would be possible now and could be included in a toolkit; but the capital requirements a provider would face in guaranteeing a future income, and the customer's option to switch to a different provider when they take the benefits, mean it is not particularly attractive to the provider or the customer.

16. Are there other ways of helping members hedge longevity risk?

Some drawdown products offer guarantees on the income and/or the capital, typically hedging through investment strategies.

17. Does investing through retirement, as an alternative to immediate annuitisation,

have a significant role to play in meeting the retirement needs of DC savers?

Yes – a key outstanding question is the extent to which investing through retirement becomes a mass market strategy. Drawdown is already increasing in popularity and is often used as a vehicle for temporary income with potential for growth for a period before annuitising. Taking uncrystallised lump sums is also investing through retirement, and time will tell how popular this strategy will be from April. In practice, some savers will invest through retirement in order to pay for care, or with a bequest motive.

18. If you were designing a default drawdown strategy for NEST members, how would you do it?

This is a matter for NEST and not appropriate for us to comment on strategy.

19. Should NEST consider some form of risk sharing as part of a solution for NEST members in retirement? If yes, what sort and why?

And

20. Would there be benefits in combining a risk sharing approach and pure DC, and if so, what would these be?

The ABI supports in principle allowing the creation of schemes that offer some kind of medium between defined contribution and defined benefit pensions, including collective defined contribution (CDC) pensions. However, we feel that there are a number of things any employer or scheme should consider before implementing such a scheme.

CDC and some other risk sharing schemes are reliant on a consistent number of people joining a scheme; otherwise returns may start to fall or in extreme circumstances collapse entirely. This creates an inherent risk of intergenerational unfairness.

It is worth noting that CDCs run somewhat counter to the principles behind the new pension freedoms. CDC relies on members' funds staying in invested throughout retirement, whereas the government intends to give people access to their entire pension pot at 55. In a CDC scheme, people would likely receive a smaller pension if they decide to access their funds early. This would likely be unacceptable to many savers.

The importance of transparency in pension schemes has been heavily stressed in recent years – including by NEST. The complexities of CDC schemes can be difficult to articulate to consumers in comparison with more individualised schemes.